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Chief, Examination Division
Austin District

Assistant Chief Counsel (Income Tax & Accounting)

Interaction of sections 62(c) and 162(h) of the Internal Revenue Code

This is in response to your memorandum of August 19, 1991, in which you request technical assistance in regard to the treatment to be accorded Texas state legislators who are in receipt of per diem allowances. State legislators whose tax homes are more than 50 miles from the state capitol building may request a per diem allowance of \$85 as reimbursement for living expenses. This payment is not substantiated to the payor. On the basis of these facts you request advice as to the following:

1. If the legislator does not substantiate his or her expenses to the payor within a reasonable period of time, is the per diem allowance included in wages on the Form W-2?
2. If the per diem allowance exceeds actual expenses, is the excess included as wages on the Form W-2?
3. What effect does section 1.62-2 of the Income Tax Regulations have on section 162(h) of the Internal Revenue Code?

Section 162(a) of the Code allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in pursuit of a trade or business. Section 1.162-2 of the regulations provides that traveling expenses include travel fares, meals and lodging, and expenses incident to travel.

In order for traveling expenses to be deductible under section 162(a) of the Code, they must be (1) reasonable and necessary, (2) incurred while away from home, and (3) incurred in the pursuit of a trade or business. Commissioner v. Flowers, 326 U.S. 465 (1946), 1946-1 C.B. 57. Only travel in which sleep or rest is required is travel "away from home." U.S. v. Correll, 389 U.S. 299 (1967), 1968-1 C.B. 64.

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If a taxpayer is traveling away from home on business, his deductible expenses include expenditures for meals and lodging, together with expenses for incidentals such as laundry and dry cleaning, telephone calls, local transportation, etc. Deductions for expenses incurred while away from home reflect a duplication or increased level of expense that the taxpayer would not have incurred in the absence of business necessity. Because an individual may only deduct living expenses incurred while away from home, it is necessary to determine the location of an individual's "tax home"

When state legislatures began to be in session for greater lengths of time, it became increasingly difficult for many state legislators to determine their tax homes. In order to provide consistent treatment to all state legislators, Congress enacted special temporary provisions dealing with the travel expenses of state legislators. Section 604 of the Tax Reform Act of 1976, 1976-3 (Vol. 1) C.B. 1, 51. Section 127 of the Economic Recovery Tax Act of 1981, 1981-2 C.B. 256, 274, modified and made permanent the prior provisions by adding section 162(h) of the Code.

Section 162(h) of the Code provides that, for purposes of section 162(a), if an individual who is a state legislator at any time during the tax year makes an election under section 162(h) for the taxable year, the individual's place of residence within the legislative district that the legislator represents will be considered the legislator's tax home for purposes of computing business expense deductions for away from home expenses. Section 162(h)(1)(B) further provides that the legislator will be deemed to have expended for living expenses (in connection with his trade or business as a legislator) an amount each legislative day that is the greater of: (1) the per diem rate allowed to federal employees while serving away from home, or (2) a state per diem rate not exceeding 110 percent of the applicable federal per diem rate. The current federal per diem rate allowable for living expenses in the City of Austin, \$85 per day, is identical to the state rate. The election under section 165(h) cannot be made by any legislator whose legislative district residence is 50 miles or less from the state capitol building.

Section 162(h)(1)(C) of the Code states that the electing legislator will be deemed to be away from home in pursuit of a trade or business on each legislative day. Section 162(h)(2) defines the term "legislative day" as any day during the tax year on which the legislature was (1) in session (including any day in which the legislature is not in session for a period of 4 consecutive days or less), or (2) not in session but the physical presence of the legislator was formally recorded at a meeting of a committee of the legislature.

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Section 162(h)(1)(C) of the Code creates a conclusive presumption that a legislator was away from home on business on each legislative day. This reversed the decision of the Tax Court in Chappie v. Commissioner, 73 T.C. 823 (1980), which affirmed the Service's position that a state legislator must comply with the normal rules requiring a taxpayer to be "away from home" in order to deduct living expenses. In essence, the "sleep or rest" requirement of U.S. v. Correll does not apply to a section 162(h) deduction.

Responding to your first question, if the legislator is eligible to make the section 162(h) election, and does so, than no substantiation of expenses is required. If the amount of the reimbursement does not exceed the allowable amount provided for in section 162(h)(1)(B) and is only paid for those days that are deemed to be "legislative days" as defined in section 162(h)(2), no amount of the reimbursement is included in income or reported on Form W-2.

In regard to your second question, use of the amount provided for in section 162(h) of the Code is deemed to be a substantiation of deductible employee business expenses. If the amount of the reimbursement does not exceed the allowable per diem rate, the amount of actual expenses is immaterial. See also Rev. Proc. 90-60, 1990-2 C.B. 651.

Section 62(c) of the Code provides that arrangements will not be treated as "reimbursement or other expense allowance arrangements" for purposes of section 62(a)(2)(A) if (1) such arrangement does not require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement, or (2) such arrangement provides the employee with the right to retain amounts in excess of the substantiated expenses covered under the arrangement.

Section 62(c) of the Code also provides that the substantiation requirement does not apply to any expense to the extent that the Commissioner has provided that substantiation is not required for such expense. For example, pursuant to section 1.62-2(e) of the regulations, Rev. Proc. 90-59, 1990-2 C.B. 644, and Rev. Proc. 90-60 provide rules under which the amount of ordinary and necessary business expenses of an employee for local travel or transportation and lodging, meals, and/or incidental expenses incurred while away from home will be deemed substantiated under section 1.274-5T of the regulations. Under section 162(h)(1)(B), a state legislator who has made the election under section 162(h) will be deemed to have expended for living expenses, in connection with his trade or business of being a legislator, the amount determined under the provisions of section 162(h)(1)(B).

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Accordingly, in regard to your third question, in the case of an electing legislator, the per diem amount determined under section 162(h)(1)(B) of the Code is deemed to be substantiated. However, the requirements of section 62(c) would need to be met in the event that advances, allowances, or reimbursements are provided for on days other than "legislative days" or for expenses incurred by the legislator that are outside the ambit of section 162(h) but that may be deductible under section 162(a).

We hope that the above information will be helpful. If we can be of further assistance, please do not hesitate to contact Leonard Friedman of my office at telephone number (202) 566-4486.

(signed) Robert A. Berkovsky

By _____
Robert A. Berkovsky
Chief, Branch 2

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